

Message Text

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SECSTATE WASHDC 3865

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AMEMBASSY TOKYO

USMISSION OECD PARIS

USMISSION EC BRUSSELS

C O N F I D E N T I A L SECTION 01 OF 02 LONDON 11383

LIMDIS GREENBACK

DEPARTMENT PASS FRB

TREASURY PASS OASIA FOR DONALD E. SYVRUD

E.O. 11652: GDS

TAGS: EFIN, UK

SUBJECT: BANK OF ENGLAND VIEWS ON THE ECONOMY

REF: LONDON 10960

SUMMARY: BANK OF ENGLAND ECONOMISTS GENERALLY CONCUR WITH H.M. TREASURY VIEWS ON THE ECONOMY, ALTHOUGH SLIGHTLY LESS OPTIMISTIC ON RATE OF GROWTH AND SOMEWHAT APPREHENSIVE ABOUT ABILITY TO BRING INFLATION BELOW 10 PERCENT. END SUMMARY.

1. FINANCIAL ATTACHE CALLED ON SENIOR ECONOMIC FORECASTER AT THE BANK OF ENGLAND (BOE) TO DISCUSS GENERAL OUTLOOK AND TRENDS. REFERRING TO LATEST INTERNAL H.M.T.

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FORECAST (SEE REFTTEL) SOURCE SAID THAT REAL GDP GROWTH OF

4 PERCENT APPEARS POSSIBLE THIS YEAR OVER 1975 WITH GROWTH OF 4.5 TO 4.75 LIKELY IN 1977. GROWTH PROFILE WILL HAVE A HUMP, WITH FIRST HALF 1977 GROWTH OVER FIRST HALF 76 ESTIMATED AT 5 PERCENT. THIS WILL BE MAJOR PERIOD FOR TAKING UP SLACK IN THE ECONOMY. MAIN IMPETUS BEHIND GROWTH AT THE MOMENT IS IN EXPORTS AND INVENTORY REBUILDING. CONSUMER DEMAND IS SEEN SLACK IN PERIOD UNDER DISCUSSION AS REAL DISPOSABLE INCOME IS SQUEEZED. BANK ECONOMISTS DO NOT EXPECT SAVINGS RATIO TO DECLINE SHARPLY; IF IT DID, GROWTH COULD BE EVEN FASTER. MANUFACTURING PRODUCTION THROUGH 1977 IS ESTIMATED TO INCREASE IN 9 TO 10 PERCENT RANGE. MANUFACTURING INVESTMENT ON 18 MONTH PERIOD FROM SECOND HALF 1976 TO END 1977 EXPECTED TO INCREASE BY 25 PERCENT (OR AT AN AVERAGE ANNUAL RATE OF 16.7 PERCENT). FINANCIAL ATTACHE ASKED FOR ELABORATION. REFERRING TO COMPUTER PRINTOUTS, SOURCE SAID TREASURY FORECAST INDICATED MANUFACTURING INVESTMENT WOULD GROW 24 PERCENT IN SECOND HALF 1977 OVER SECOND HALF 1976; I.E., NEARLY ALL OF THE GROWTH WOULD BE IN THE PERIOD JAN-DEC 1977.

2. BOE RECOGNIZES THAT BOTTLENECKS COULD OCCUR AND EXPECTED THERE WOULD BE SOME STRAINS PLACED ON THE ECONOMY, BUT AT THE MOMENT STEEL IS THE ONLY AREA THAT HAS BEEN POSITIVELY IDENTIFIED. BANK ECONOMISTS ARE LESS OPTIMISTIC THAN HMT OFFICIAL PRONOUNCEMENTS ON RATE OF GROWTH OF PRICES. SLIPPAGE IN THE 6 POUND PAY POLICY WILL PUT AVERAGE EARNINGS AT ABOUT 14 TO 15 PERCENT FROM AUGUST 1975 TO AUGUST 1976. THIS IS 3 PERCENT HIGHER THAN HAD BEEN EXPECTED. IN ADDITION, FALL IN THE STERLING EXCHANGE RATE WHICH HAD COME EARLIER THAN ANTICIPATED AND INCREASES IN COMMODITY PRICES LEAD BOE ECONOMISTS TO CONSIDER RATE OF INFLATION WILL NOT FALL BELOW 13 PERCENT BY THE END OF THE YEAR AND THE UK MAY BE VERY LUCKY INDEED TO GET THE RATE OF INFLATION BELOW 10 PERCENT BY THE MIDDLE OF NEXT YEAR. CHANCELLOR HEALEY MAY REGRET HIS APRIL BUDGET STATEMENT THAT THE RATE OF INFLATION COULD BE HALVED AGAIN BY THE END OF NEXT YEAR. THIS JUST DOES NOT SEEM TO BE IN THE CARDS.

3. UNEMPLOYMENT ON A SEASONALLY ADJUSTED BASIS IS EXPECTED TO INCREASE FURTHER, POSSIBLY UP TO 1.4 MILLION BEFORE IT BEGINS TO COME DOWN SLOWLY IN THE 4TH QUARTER OF THIS YEAR.

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4. THE POOR SECOND QUARTER TRADE FIGURES ARE ALSO CITED AS A CAUSE OF CONCERN. AT AN ANNUAL RATE, THE FIRST HALF YEAR'S CURRENT DEFICIT IS RUNNING AT 1.2 BILLION POUNDS. HOWEVER, IF THE 2ND QUARTER'S PERFORMANCE, WITH THE IN-

CREASE IN IMPORT VOLUME, IS MAINTAINED FOR THE REST OF THE YEAR, THE OUTCOME WILL BE MORE IN THE 1.8 BILLION CURRENT DEFICIT RANGE. THE BOE THINKS THE OUTCOME COULD BE SOMEWHERE WITHIN, AND POSSIBLY TOWARDS THE MIDDLE TO

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LIMDIS GREENBACK

UPPER END,OF THIS RANGE. WHEREAS THE FIRST QUARTER WAS ESPECIALLY GOOD, THE 2ND QUARTER DEFICIT DID INCLUDE SOME SPECIAL FACTORS WHICH HAD A NEGATIVE IMPACT--ESPECIALLY NORTH SEA OIL EQUIPMENT. IF THE GROWTH OF IMPORTS OF FINISHED MANUFACTURES PICKS UP SHARPLY, THIS WILL BE A CAUSE OF SERIOUS CONCERN.

5. TURNING TO THE ROUGHLY 1 BILLION POUNDS IN EXPENDITURE CUTS TO BE ANNOUNCED TODAY, THE SOURCE INDICATED THAT THE PACKAGE ON ITS OWN LOOKS WEAK, ESPECIALLY IF IT IS DESIGNED TO IMPRESS FOREIGN CREDITORS. ONE POSSIBILITY IN FLESHING IT OUT WILL BE AT THE SAME TIME TO ANNOUNCE SOME FORM OF MONETARY TARGET. IF THE DECISION IS TAKEN

TO DO SO, THE TARGET WILL NOT BE AS SOPHISTICATED OR NU-
ANCED AS THAT USED IN THE U.S.

6. SOURCE NOTED THAT BASED ON KEYNESIAN THEORY, THERE IS
REALLY NO NEED FOR CUTTING PUBLIC EXPENDITURE, GIVEN THE
CURRENT LEVEL OF UNEMPLOYMENT. HOWEVER, GIVEN THE EXPEC-
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TED UPTURN IN ACTIVITY AND POSSIBLE RESURGENCE OF INFLA-
TION NEXT YEAR, PERHAPS COUPLED WITH A DECLINE IN THE
SAVINGS RATIO, THE PUBLIC EXPENDITURE CUTS ARE A GOOD
IDEA IN TERMS OF MAKING NECESSARY RESOURCES AVAILABLE
TO THE PRIVATE SECTOR AND AVOIDING CROWDING OUT.

7. IN TERMS OF EXCHANGE MARKET REACTION TO THE CUTS, THE
BEST THAT THIS OFFICIAL HOPED FOR WOULD BE THAT THE POUND
WOULD REMAIN STABLE IN THE \$1.80 RANGE THROUGH THE END OF
THE YEAR. THE BOE HAS APPARENTLY DECIDED NOT TO PLACE A
"CAP" ON HOW HIGH THE POUND WOULD BE ALLOWED TO RISE
SHOULD MARKET SENTIMENT TAKE IT HIGHER. AFTER THE DISAS-
TROUS EXPERIENCE IN MARCH, THE MARKET MUST BE CONVINCED
THAT THERE CAN BE A GENUINE 2-WAY STERLING MARKET WITHOUT
THE BOE AGGRESSIVELY CREAMING OFF FUNDS TO RECOUP RESERVES
(THIS VIEW HAS BEEN ECHOED BY OTHER BOE OFFICIALS.) DUR-
ING DISCUSSION OF FOREIGN EXCHANGE MARKET SENTIMENT,
SOURCE ACKNOWLEDGED THAT MANAGEMENT OF STERLING IS COM-
PLICATED BY DESIRE TO MAINTAIN CONSTANT COMPETITIVENESS
ON CURRENT ACCOUNT, NEED TO REASSURE STERLING HOLDERS,
AND MARKET BELIEF THAT AT SOME POINT BOE WOULD HOPE TO RE-
COUP SOME OF ITS RESERVE LOSSES. IN PART, REVERSAL OF
LEADS AND LAGS COULD AID THE BANK IN REBUILDING RESERVES.
OFFICIALS IN THE BOE CONSIDER THAT STERLING BALANCES WHICH
HAVE REMAINED; I.E., WHICH WERE NOT WITHDRAWN IN THE
MARCH-JUNE PERIOD, APPEAR PRETTY STABLE, ALTHOUGH OUTLOOK
FOR ADDITIONAL DEPOSITS IS PROBLEMATIC. GIVEN DIFFERENCES
IN COMPARATIVE INFLATION RATES, BOE OFFICIALS EXPECT STER-
LING TO DECLINE FURTHER (GENTLY THEY HOPE) ON A TRADE-
WEIGHTED BASIS DURING 1977.

8. ANOTHER SENIOR BOE OFFICIAL TOLD FINANCIAL ATTACHE
THAT BOE IS SEEKING 5-YEAR BULLET LOANS (I.E.,
NO REPAYMENT OF PRINCIPAL UNTIL MATURITY) BECAUSE OF ITS
DEBT SERVICING SCHEDULE DURING THE NEXT FEW YEARS. SOME
U.S. BANKS HAVE OFFERED 4 TO 7 YEAR MONEY BUT WITH AN
AMORTIZATION SCHEDULE THROUGHOUT THE LIFE OF THE LOAN.
BOE IS NOT TAKING THESE.

ARMSTRONG

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